Economic & Market Update, March 2015

Return to Fantasyland

By Richard Morey

February was another very strange month for the markets. Stocks recouped their losses from January while bonds lost approximately half of their gains from January. In January investors were worried about the economy, corporate earnings, and stock prices. They therefore sold stocks at lower prices and purchased bonds at higher prices. Then in February investors decided the economy was really growing nicely, finally reaching that elusive "escape velocity," and corporate earnings were therefore going to expand. They drove up stock prices and down bond prices. In this report we are going to attempt to determine which view was correct, using a few charts to clear the mists.

U.S. Economic "Growth"

According to the mainstream media and stock investors, in February we saw a very clear upswing in U.S. economic performance relative to January. Were they correct? There were 40 pieces of economic data announced in February. The last one was a revision of fourth quarter U.S. economic growth, which was lowered from 2.6% to 2.2%. So that's one in the negative column. The following chart lists the other 39 announcements showing how the economy is performing. The top portion lists those that came in below expectations, followed by those that showed increasing growth in the economy:

February US economic data: above or below expectations

MISSES

- Personal Spending
- Construction Spending
- ISM New York
- Factory Orders
- Ward's Domestic Vehicle Sales
- ADP Employment
- Challenger Job Cuts
- Initial Jobless Claims
- Nonfarm Productivity
- Trade Balance
- Unemployment Rate
- Labor Market Conditions Index
- NFIB Small Business Optimism
- Wholesale Inventories
- Wholesale Sales
- IBD Economic Optimism
- Mortgage Apps
- Retail Sales
- Bloomberg Consumer Comfort
- Business Inventories
- UMich Consumer Sentiment
- Empire Manufacturing
- NAHB Homebuilder Confidence
- Housing Starts
- Building Permits
- PPI
- Industrial Production
- Capacity Utilization
- Manufacturing Production
- Dallas Fed
- Chicago Fed NAI
- Existing Home Sales
- Consumer Confidence
- Richmond Fed

BEATS

- Personal Income
- Nonfarm Payrolls
- JOLTS
- Markit Services PMI
- Case-Shiller Home Price

Source: Bloomberg via Zero Hedge

That chart speaks for itself. To put it into perspective, this is the worst performance for the economy since 2009. The data is very clearly telling anyone willing to listen that the trajectory of the U.S. economy is down at this time. Fed Chairperson Janet Yellen made one (of many) humorous comments in her testimony before Congress last week. She described the U.S. economy as clearly on the upswing. We have a strong economy – no doubt about it – but she then said the only problem is "the data just isn't cooperating." In February investors decided they should believe Janet Yellen and the Fed, no doubt about it, rather than the data.

Corporate Earnings

Stock prices are more over-priced than at any time in history other than at the end of the tech bubble in 2000. Thinking back to that time period recently, I realized one could have made a case for stocks in the year 2000, even though their prices had skyrocketed and were clearly far beyond all historic norms. Unlike today, the economy was doing exceptionally well. Government debt was low, good jobs were relatively plentiful, and there were really no serious economic clouds on the horizon, either here or around the world. Of course, at the end of the day the stock market is significantly more highly correlated to corporate earnings than current economic performance. And from the standpoint of corporate earnings the beginning of 2000 showed the greatest growth in history. Except for the money-losing "dot.com" tech companies, most of our major corporations were seeing their earnings growth explode upwards. So while investing in stocks in 2000 would obviously have been a terrible idea, as stocks got cut in half shortly thereafter (with technology stocks losing 74%!), a rational person could have made a case the stock market was the place to invest.

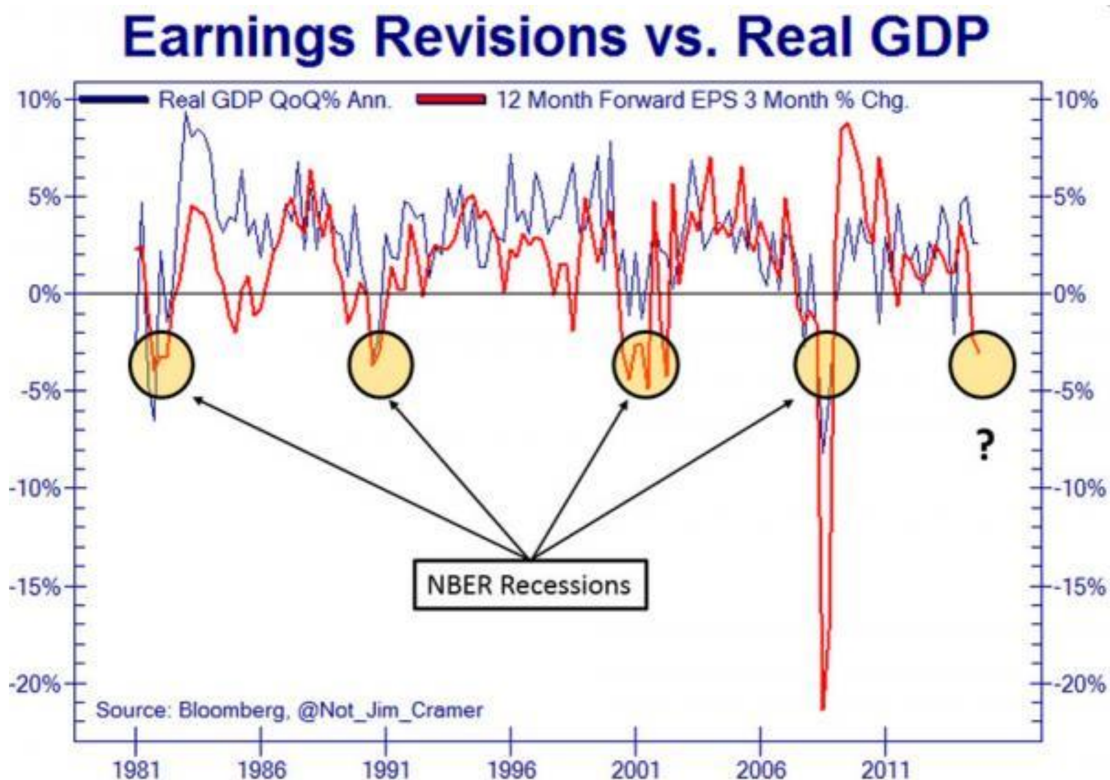
Fast forward to today and we see a completely different picture. As shown above, the economic data is turning down. Perhaps we will be able to continue to expand at the subpar rate we have had year after year since 2010, or perhaps the economy will finally turn negative. While the jury is still out on when we will have the next recession, corporate earnings are already going down – hard and fast. According to the Bureau of Economic Analysis, data from the IRS shows corporate profits dropped in each of the first three quarters of 2014 (fourth quarter numbers are not yet available). And in the third quarter, the after-tax profits (adjusted for inventory gains/losses and over/under depreciation) were ***7% below a year ago***. (From Dr. Lacy Hunt, manager of the Wasatch-Hoisington U.S. Treasury fund.)

That last sentence should send fear coursing through every stock investor. Ultimately stock prices are mainly dependent on corporate earnings. When stock prices are severely overpriced as they are today *and* earnings are going down, stocks get killed (and bonds usually roar).

Now let's look forward. For the first time since early 2009, companies now expect their total sales to decrease in 2015. Sales growth has been quite poor overall since 2009, but this is expected to be the first year they actually go down. Looking at earnings, the following chart shows the corporate earnings estimates for this year versus the stock market. It shows companies are now expecting their earnings to be far, far below what they had previously expected in 2015. Combined with the drop in profits last year, at some point investors will notice the companies whose stocks they are buying are doing poorly.

Once again, this chart speaks for itself. The core reason people own stocks, and the core reason stocks rise in price, is that a company is making more money. I think this makes sense to everyone. When companies are earning less money, stock prices always come tumbling down.

Next we'll look at a chart that combines corporate earnings with the economy. The red line shows the extent corporate earnings have been lowered. As you can see, each of the last four times (since 1980) earnings were revised as low as they are today the U.S. economy has ended up in recession.



Does this mean the U.S. economy has either recently entered a recession or will be in one shortly? The data is not clear enough yet to answer this question. In fact, the reported economic numbers never turn down sufficiently before an actual recession to accurately predict one is coming. That being said, if you had to pick one forward-looking indicator, corporate earnings would be one of the best. When companies begin to earn less, the economy is nearly always falling.

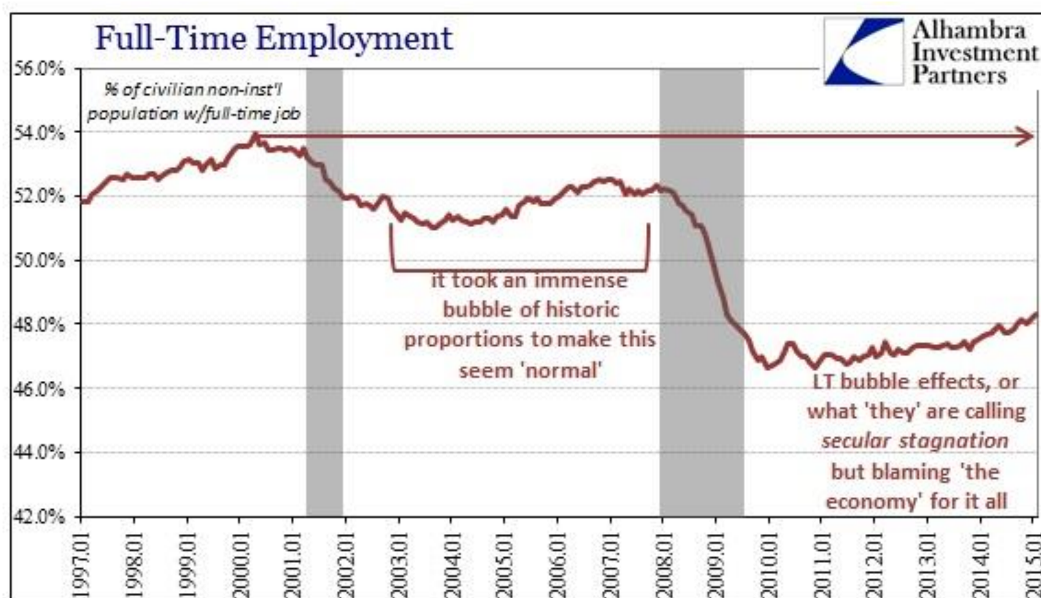
You should also keep in mind we do not need the economy to drop much to see stock prices plummet. From 2001-2002 the economy only contracted .3% during that recession, while stock prices crashed. If the rest of the world didn't exist, we would expect the next U.S. recession to most likely be fairly modest. That should not, however, give stock investors any comfort, given the fact stocks lost half of their value from 2001-2002 even though the recession was quite mild. Of course, the rest of the world does exist, and a large shock to the troubled economies of the Eurozone, Japan and/or China would lead to a much more severe economic downturn here in the United States.

What is Causing these Economic Problems?

Here in the United States, our current problems have two main sources:

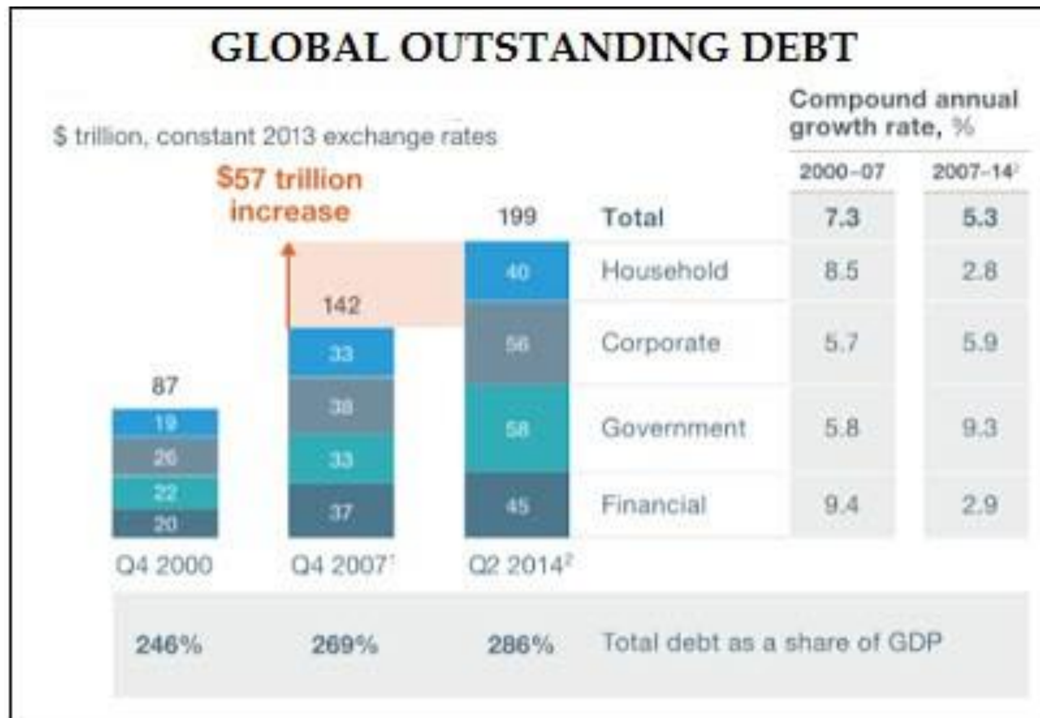
1) Income and employment. In February investors were giddy with enthusiasm in the belief our "phenomenally good" jobs market was a clear sign the economy was finally taking off. However, this is similar to looking at the Greek economy, which grew approximately 2% in 2014, and therefore declaring victory without remembering their economy had collapsed 30% in previous years.

   In reality, the jobs market in the U.S. is far, far from being phenomenally good. In fact, it is just the opposite. The "U-6" unemployment number which (attempts to) measure all the people who need a full-time job but do not have one ended January at 11.3% (from the Bureau of Labor Statistics). This is the "real" unemployment number in this country, as only full-time jobs keep people out of poverty. This is illustrated in the following chart, which shows the percent of our working age population with a full-time job now stands at 48%. Less than half of the working age adults in this country have a full-time job, which is the lowest number since the 1970s, and today over 100 million working age adults are unemployed.



In terms of income, as discussed in last month's report, the average income for U.S. households has dropped by 7% since 2008. Real median household income is still below 1989 levels. In other words, the average citizen in our country has not seen an actual raise in over 25 years! The economy – and corporate profits – simply cannot grow sustainably when people have less and less money.

2) Debt. When the history of this time period is written in the future, it will say we had a debt crisis in 2008-2009, and the worldwide response was a further explosion of total debt. This is highly likely to lead to a disturbingly negative ending to the story. The following chart by McKinsey and Company shows the growth of total debt in the world since 2000:



(Measuring debt around the world is difficult, and I have read other analysts who claim it has increased by a full 50% since 2009. Still, there is no doubt debt has ballooned and continues to do so.)

Summary

February was most likely the "calm before the storm" for world stock markets. Here in the U.S., the combination of historically over-priced stocks with a slowing economy and plunging corporate profits is pretty much the worst scenario one could envision for future stock performance. However, we will not see risk assets fall seriously in price until investors finally decide to pay attention to economic reality instead of blindly believing the make-believe world the Fed and media describes to them.

For the bond market, everything that should lead to caution regarding stocks leads to optimism for the highest-quality U.S. bonds – particularly U.S. Treasuries (government bonds). Stocks will end up lower – most likely more than 40% – and whenever this occurs the yield or interest on the 10 Year Treasury will likely be cut in half, falling all the way down to around 1%. This will lead to large price gains for these bonds and even larger gains for longer-term Treasuries.

When will this occur? I really have no idea, as it would already have occurred some time ago if it was based on a rational analysis of economics. But in the short to intermediate term, stock prices are determined

not by rational analysis but by human emotion. As long as investors are excited about making money in stocks, regardless of their plunge in earnings in a slowing economy, stocks will continue to rise or, at worst, suffer only small losses. However, at some point investors will wake up to economic reality.

Almost anything, here or abroad, could spark this awakening. I recently read an article equating the turning points in stocks to an avalanche. You can have 100 feet of unstable snow with no avalanche, and then all of a sudden the next snowflake leads it all to come tumbling down. You cannot predict which snowflake will be the ultimate catalyst. Today there are literally hundreds of events that could be the one which will lead investors to look at the stock market and decide it is far too high and the risks are far too large for comfort. And then, very quickly millions of other investors will see the same picture and decide to sell their stocks in panic at the same time.

This is why the notion a person will be able to get out of the market before suffering large losses is flawed. When millions of people have that same idea, they try to sell stocks at the exact same time. As a result, instead of falling modestly the market drops precipitously very quickly. Seeing this, others decide they should wait for a while until stocks go back up – which they do. After rebounding, everyone sighs in relief. But then stocks drop a large amount again. By then most investors are unwilling to sell at prices so much lower. Plus, they remember stocks rebounded the last time they dropped quickly. So they continue to hold, and lo and behold stocks do rebound once again. However, a short time later they drop even further. This typically occurs over and over, and each time stocks rebound somewhat people are hopeful the worst is now behind them. This is precisely what occurred to technology stocks from 2000-2002. During these years these stocks actually rose over 15% four separate times. Each time investors breathed a huge sigh of relief, thinking the huge losses were behind them. Unfortunately, each time they proceeded to go down even further. So despite having four time periods in which tech stocks did very well, lulling investors into believing the problems were finally in the rearview mirror, by the end those stocks had crashed down 74%.

So instead of attempting to wait until the last moment to sell (along with millions of others), a much wiser and successful approach is to sell out of any market when it is in an actual bubble and then patiently wait to buy back in when stocks are low. This is called "selling high and buying low." Nearly everyone says this is how one should invest, yet hardly anyone has the intestinal fortitude to follow this advice. For most, it is very, very difficult to not be invested in a market that has gone up dramatically and continues to rise. But this is a partial description of a bubble, and they always end in tears.

At Secure Retirement we simply will not be invested in any bubble – no matter how appealing it looks today – as they always lead to extreme losses that wipe out all the previous gains. Not being able to predict when the bubble will pop, and recognizing bubbles nearly always last far longer than any sane person would expect, this discipline requires some serious patience and, I would say, a good amount of courage. However, while it can be trying to forego the gains others are receiving by participating in the bubble, we are much more focused on avoiding the suffering we know will be the end result. Fortunately, as the air is exiting the bubble our clients at Secure Retirement will be receiving very solid profits – a fact which should quickly and happily erase any lingering concerns from having not received the profits as the bubble expanded – profits that disappear during the popping process.